

on the expected realization of revenue. Discovery incurs sales and marketing expense to promote brand recognition and to secure quality distribution channels worldwide.

Discovery produces original programming and acquires content from numerous producers worldwide that is tailored to the specific preferences of viewers around the globe. Discovery believes it is generally well positioned for continued access to a broad range of high-quality programming for both its U.S. and international networks. It has assembled one of the largest libraries of non-fiction programming and footage in the world, due both to the aggregate purchasing power of its many networks and a policy to own as many rights as possible in the programs aired on its networks. Discovery also has long-term relationships with some of the world's most significant non-fiction program producers, including the British Broadcasting Corporation, which we refer to as the BBC. Discovery believes the broad international appeal of its content combined with its ability to utilize its programming library on a global basis is one of its competitive advantages. Discovery is also developing programming applications designed to position the company to take advantage of emerging distribution technologies including video-on-demand, IP-delivered programming and mobile.

Discovery's other properties consist of Discovery.com and over 100 retail outlets that offer technology, kids, lifestyle, health, science and education oriented products, as well as products related to other programming offered by Discovery. Additionally, Discovery's newest division, Discovery Education, distributes digital-based educational products to schools and consumers primarily in the United States.

Discovery is a leader in offering solutions to advertisers that allow them to reach a broad range of audience demographics in the face of increasing fragmentation of audience share. The overall industry is facing several issues with regard to its advertising revenue, including (1) audience fragmentation caused by the proliferation of other television networks, video-on-demand offerings from cable and satellite companies and broadband content offerings; (2) the deployment of digital video recording devices (DVRs), allowing consumers to time shift programming and skip or fast-forward through advertisements; and (3) consolidation within the advertising industry, shifting more leverage to the bigger agencies and buying groups.

#### **Discovery Networks U.S.**

Discovery networks U.S. currently operates 12 channels and provides distribution and advertising sales services for BBC America and distribution services for BBC World News. The division's channels include the Discovery Channel, TLC, Animal Planet, Travel Channel, Discovery Health Channel, Fit TV and the following emerging digital tier networks: The Science Channel, Discovery Kids, The Military Channel, Discovery Home, Discovery Times and Discovery HD Theater, which we refer to collectively as the emerging networks. All of these channels are wholly owned by Discovery other than Animal Planet, in which Discovery has an 80% ownership interest. Cox Communications, Advance/Newhouse and a subsidiary of Discovery Holding Company, combined, own the remaining 20% interest in Animal Planet. Discovery networks U.S. also operates web sites related to its channel businesses and various other new media businesses, including a video-on-demand offering distributed by various cable operators.

#### **Discovery Networks International**

Discovery networks international, or the international networks, manages a portfolio of channels, led by Discovery Channel and Animal Planet, that are distributed in virtually every pay-television market in the world via an infrastructure that includes major operational centers in London, Singapore, New Delhi and Miami. Discovery networks international currently operates over 100 separate feeds in 35 languages with channel feeds customized according to language needs and advertising sales opportunities. Most of the division's channels are wholly owned by Discovery with the exception of (1) the international Animal Planet channels, which are generally 50-50 joint ventures with the BBC, (2) People + Arts, which operates in Latin America and Iberia as a 50-50 joint venture with the BBC and (3) several channels in Japan and Canada, which operate as joint ventures with strategically important local partners. As with the U.S. networks division, the international networks division operates web sites and other new media businesses.

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#### **Discovery Commerce, Education & Other**

This group includes Discovery commerce, which operates a chain of retail stores in the United States that offer technology, kids, lifestyle, health, science and education-oriented products, as well as products specifically related to programming on Discovery's networks. This division also operates a catalog and electronic commerce business selling products similar to that sold in the Discovery Channel Stores, as well as a business that licenses Discovery trademarks and intellectual property to third parties for the purpose of creating and selling retail merchandise.

This group also includes Discovery education. In 2004, the company expanded beyond its traditional education businesses of airing educational programming on its networks and selling hard copies of such programs to schools and

began streaming educational video material into schools via the Internet. Discovery education now operates *United-streaming*, *Power-Media-Plus* and *Cosmeo*, some of the leading educational broadband streaming services in the United States. These services earn revenue through subscription fees paid by schools, school districts and consumers which use the services.

#### **Discovery Stockholders' Agreement**

A subsidiary of ours, together with a subsidiary of Cox Communications, which we refer to as Cox Communications, and Advance/Newhouse Programming Partnership, which we refer to as Advance/Newhouse, and John Hendricks, the founder and Chairman of Discovery, are parties to a Stockholders' Agreement. We own 50%, and Cox Communications and Advance/Newhouse each own 25%, of Discovery. Mr. Hendricks is the record holder of one share of capital stock of Discovery; however, Mr. Hendricks cannot transfer this share, the share is subject to an irrevocable proxy in favor of Advance/Newhouse and the share is subject to a call arrangement pursuant to which Advance/Newhouse can purchase the share. Accordingly, we treat such share as being owned by Advance/Newhouse for purposes of Advance/Newhouse's percentage ownership of Discovery as described in this Annual Report. As a "close corporation" under Delaware law, the stockholders manage the business of Discovery, rather than a board of directors. The Stockholders' Agreement provides that a number of decisions affecting Discovery, such as, among other things, a decision to effect a fundamental change in its business, a merger or other business combination, issuance of Discovery's equity securities, approval of transactions between Discovery, on the one hand, and any of its stockholders, on the other hand, and adoption of Discovery's annual business plan, must be approved by the holders of 80% of its outstanding capital stock. In addition, other matters, such as the declaration and payment of dividends on its capital stock, require the approval of the holders of a majority of Discovery's outstanding capital stock.

Because we own 50%, Cox Communications owns 25% and Advance/Newhouse owns 25% of the stock of Discovery, any one of us may block Discovery from taking any action that requires 80% approval. In addition, because Cox Communications and Advance/Newhouse, on the one hand, and our company, on the other, each owns 50% of the outstanding stock of Discovery, there is the possibility that the stockholders could deadlock over various other matters, which require the approval of the holders of a majority of its capital stock. To reduce the possibility that this could occur, the stockholders have given John Hendricks, the founder and Chairman of Discovery, the right (but not the obligation), subject to certain limitations, to cast a vote to break a deadlock on certain matters requiring a majority vote for approval.

The Stockholders' Agreement also restricts, subject to certain exceptions, the ability of a stockholder to transfer its shares in Discovery to a third party. Any such proposed transfer is subject to a pro rata right of first refusal in favor of the other stockholders. If all of the offered shares are not purchased by the other stockholders, then the selling stockholder may sell all of the offered shares to the third party that originally offered to purchase such shares at the same price and on the same terms, provided that such third party agrees to be bound by the restrictions contained in the Stockholders' Agreement. In addition, in the event that either Cox Communications or Advance/Newhouse proposes to transfer shares, Cox Communications or Advance/Newhouse, whichever is not proposing to transfer, would have a preemptive right to buy the other's shares, and if it does not elect to purchase all such shares, then the remaining shares would be subject to the pro rata right of first refusal described above.

The Stockholders' Agreement also prohibits Cox Communications, Advance/Newhouse and our company from starting, or acquiring a majority of the voting power of, a basic programming service carried in the United States that consists primarily of documentary, science and nature programming, subject to certain exceptions.

In connection with the spin off, Liberty contributed to us 100% of an entity that owns a 10% interest in the Animal Planet limited partnership. Our partners in this entity include Discovery, Cox Communications and Advance/Newhouse. The Stockholders' Agreement prohibits us from selling, transferring or otherwise disposing of either of the subsidiaries that hold the Discovery interest or Animal Planet interest, respectively, unless, after such transaction, such subsidiaries are controlled by the same person or entity.

The foregoing summary of the Discovery Stockholders' Agreement is qualified by reference to the full text of the agreement and amendments.

#### **Regulatory Matters**

##### **Ascent Media**

Some of Ascent Media's subsidiary companies hold licenses and authorizations from the Federal Communications Commission, or FCC, required for the conduct of their businesses, including earth station and various classes of wireless licenses and an authorization to provide certain services pursuant to Section 214 of the Communications Act. Most of the FCC licenses held by such subsidiaries are for transmit/receive earth stations, which cannot be operated without

individual licenses. The licenses for these stations are granted for a period of fifteen years and, while the FCC generally renews licenses for satellite earth stations, there can be no assurance that these licenses will be renewed at their expiration dates. Registration with the FCC, rather than licensing, is required for receiving transmissions from domestic satellites from points within the United States. Ascent Media relies on third party licenses or authorizations when it and its subsidiaries transmit domestic satellite traffic through earth stations operated by third parties. The FCC establishes technical standards for satellite transmission equipment that change from time to time and requires coordination of earth stations with land-based microwave systems at certain frequencies to assure non-interference. Transmission equipment must also be installed and operated in a manner that avoids exposing humans to harmful levels of radio-frequency radiation. The placement of earth stations or other antennae also is typically subject to regulation under local zoning ordinances.

### Discovery

In the United States, the FCC regulates the providers of satellite communications services and facilities for the transmission of programming services, the cable television systems that carry such services and, to some extent, the availability of the programming services themselves through its regulation of program licensing. Cable television systems in the United States are also regulated by municipalities or other state and local government authorities and are currently subject to federal rate regulation on the provision of basic service. Continued rate regulation or other franchise conditions could place downward pressure on the fees cable television companies are willing or able to pay for the Discovery networks. Regulatory carriage requirements also could adversely affect the number of channels available to carry the Discovery networks.

The Cable Television Consumer Protection and Competition Act of 1992 (the 1992 Cable Act) directed the FCC to promulgate regulations regarding the sale and acquisition of cable programming between multi-channel video programming distributors (including cable operators) and satellite-delivered programming services in which a cable operator has an attributable interest. Because cable operators have an attributable interest in Discovery, the Discovery networks are subject to these rules. The legislation and the implementing regulations adopted by the FCC preclude virtually all exclusive programming contracts between cable operators and satellite programmers affiliated with any cable operator and the 1992 Cable Act requires that such affiliated programmers make their programming services available to cable operators and competing multi-channel video programming distributors on terms and conditions that do not unfairly discriminate among distributors. As a result, Discovery has not been, and will not be, able to enter into exclusive distribution agreements, which could provide more favorable terms than non-exclusive agreements. The contract exclusivity restrictions will sunset in 2007, unless extended by the FCC. The FCC is expected to initiate a proceeding to consider the extension of the contract exclusivity rules early in 2007.

The 1992 Cable Act required the FCC, among other things, to prescribe rules and regulations establishing reasonable limits on the number of channels on a cable system that will be allowed to carry programming in which the owner of such cable system has an attributable interest. In 1993, the FCC adopted such channel carriage limits. However, in 2001, the United States Court of Appeals for the District of Columbia Circuit found that the FCC had failed to adequately justify the channel carriage limit, vacated the FCC's decision and remanded the rule to the FCC for further consideration. In response to the Court's decision, the FCC issued a further notice of proposed rulemaking in 2001 to consider channel carriage limitations. The FCC issued a Second Further Notice of Proposed Rulemaking on May 17, 2005, requesting comment on these issues. If such channel carriage limitations are implemented, the ability of Cox Communications and Advance/Newhouse to carry the full range of Discovery's networks could be limited.

The 1992 Cable Act granted broadcasters a choice of must carry rights or retransmission consent rights. The rules adopted by the FCC generally provided for mandatory carriage by cable systems of all local full-power commercial television broadcast signals selecting must carry rights and, depending on a cable system's channel capacity, non-commercial television broadcast signals. Such statutorily mandated carriage of broadcast stations coupled with the provisions of the Cable Communications Policy Act of 1984, which require cable television systems with 36 or more "activated" channels to reserve a percentage of such channels for commercial use by unaffiliated third parties and permit franchise authorities to require the cable operator to provide channel capacity, equipment and facilities for public, educational and government access channels, could adversely affect the Discovery networks by limiting their carriage of such services in cable systems with limited channel capacity. In 2001, the FCC adopted rules relating to the cable carriage of digital television signals. Among other things, the rules clarify that a digital-only television station can assert a right to analog or digital carriage on a cable system. The FCC initiated a further proceeding to determine whether television stations may assert rights to carriage of both analog and digital signals during the transition to digital television and to carriage of all digital signals ("multicast must carry"). On February 10, 2005, the FCC denied mandatory dual carriage of a television station's analog and digital signals during the digital television transition and mandatory carriage of all digital

signals, other than its "primary" signal. Television station owners have petitioned the FCC to reconsider its decision and are seeking legislative change. Those petitions are still pending. In addition, Congress may address this issue.

In 2004, the FCC's Media Bureau conducted a notice of inquiry proceeding regarding the feasibility of selling video programming services "a la carte", i.e. on an individual or small tier basis. The Media Bureau released a report in November 2004, which concluded that a la carte sales of video programming services would not result in lower video programming costs for most consumers and that they would adversely affect video programming networks. On February 9, 2006, the Media Bureau released a new report which stated that the 2004 report was flawed and which concluded that a la carte sales could be in the best interests of consumers. Although the FCC likely cannot mandate a la carte sales, its endorsement of the concept could encourage Congress to consider proposals to mandate a la carte sales or otherwise seek to impose greater regulatory controls on how a la carte programming is sold. The programming companies that distribute these services in tiers or packages of programming services could experience decreased distribution if a la carte carriage were mandated.

In general, authorization from the FCC must be obtained for the construction and operation of a communications satellite. Satellite orbital slots are finite in number, thus limiting the number of carriers that can provide satellite transponders and the number of transponders available for transmission of programming services. At present, however, there are numerous competing satellite service providers that make transponders available for video services to the cable industry. The FCC also regulates the earth stations uplinking to and/or downlinking from such satellites.

The regulation of programming services is subject to the political process and has been in constant flux over the past decade. Further material changes in the law and regulatory requirements must be anticipated and there can be no assurance that our business will not be adversely affected by future legislation, new regulation or deregulation.

#### **International Regulatory Matters**

Video distribution and content businesses are regulated in each of the countries in which we operate. The scope of regulation varies from country to country, although in some significant respects regulation in Western European markets is harmonized under the regulatory structure of the European Union, which we refer to as the EU. Adverse regulatory developments could subject our businesses to a number of risks. Regulations could limit growth, revenue and the number and types of services offered. In addition, regulation may restrict our operations and subject them to further competitive pressure, including restrictions imposed on foreign programming distributors that could limit the content they may carry in ways that affect us adversely. Failure to comply with current or future regulation of our businesses could expose our businesses to various penalties.

#### **Competition**

The creative media services industry is highly competitive, with much of the competition centered in Los Angeles, California, the largest and most competitive market, particularly for domestic television and feature film production as well as for the management of content libraries. We expect that competition will increase as a result of industry consolidation and alliances, as well as from the emergence of new competitors. In particular, major motion picture studios such as Paramount Pictures, Sony Pictures Corporation, Twentieth Century Fox, Universal Pictures, The Walt Disney Company, Metro-Goldwyn-Mayer and Warner Brothers, while Ascent Media's customers, can perform similar services in-house with substantially greater financial resources than Ascent Media's, and in some cases significant marketing advantages. These studios may also outsource their requirements to other independent providers like us or to other studios. Thomson, a French corporation, is also a major competitor of Ascent Media, particularly under its Technicolor brand, as is Kodak through its Laser Pacific division. Ascent Media also actively competes with certain industry participants that have a unique operating niche or specialty business. There is no assurance that Ascent Media will be able to compete effectively against these competitors. Ascent Media's management believes that important competitive factors include the range of services offered, reputation for quality and innovation, pricing and long-term relationships with customers.

The business of distributing programming for cable and satellite television is highly competitive, both in the United States and in foreign countries. Discovery competes with other programmers for distribution on a limited number of channels. Increasing concentration in the multichannel video distribution industry could adversely affect Discovery by reducing the number of distributors available to carry Discovery's networks, subjecting more of Discovery's subscriber fees to volume discounts and increasing the distributors' bargaining power in negotiating new affiliation agreements. Once distribution is obtained, Discovery's programming services compete, in varying degrees, for viewers and advertisers with other cable and off-air broadcast television programming services as well as with other entertainment media, including home video, pay-per-view services, online activities, movies and other forms of news, information and entertainment. Discovery also competes, to varying degrees, for creative talent and programming content. Discovery's

management believes that important competitive factors include the prices charged for programming, the quantity, quality and variety of the programming offered and the effectiveness of marketing efforts.

#### **Employees**

We currently have no corporate employees. Liberty provides us with certain management and administrative services pursuant to a services agreement, which includes the services of our executive officers some of whom remain executive officers of Liberty.

As of December 31, 2006, Ascent Media had approximately 4,000 employees, most of which worked on a full-time basis. Approximately 2,900 of Ascent Media's employees were employed in the United States, with the remaining 1,100 employed outside the United States, principally in the United Kingdom and the Republic of Singapore. Approximately 400 of Ascent Media's employees belong to either the International Alliance of Theatrical Stage Employees in the United States or the Broadcasting Entertainment Cinematograph and Theatre Union in the United Kingdom.

As of December 31, 2006, Discovery had approximately 4,500 employees.

#### **(d) Financial Information About Geographic Areas**

For financial information related to the geographic areas in which we do business, see note 17 to our consolidated financial statements found in Part II of this report.

#### **(e) Available Information**

All of our filings with the Securities and Exchange Commission (the "SEC"), including our Form 10-Ks, Form 10-Qs and Form 8-Ks, as well as amendments to such filings are available on our Internet website free of charge generally within 24 hours after we file such material with the SEC. Our website address is [www.discoveryholdingcompany.com](http://www.discoveryholdingcompany.com).

Our corporate governance guidelines, code of ethics, compensation committee charter, and audit committee charter are available on our website. In addition, we will provide a copy of any of these documents, free of charge, to any shareholder who calls or submits a request in writing to Investor Relations, Discovery Holding Company, 12300 Liberty Boulevard, Englewood, Colorado 80112, Tel. No. (866) 876-0461.

The information contained on our website is not incorporated by reference herein.

#### **Item 1A. Risk Factors.**

An investment in our common stock involves risk. You should carefully consider the risks described below, together with all of the other information included in this annual report in evaluating our company and our common stock. Any of the following risks, if realized, could have a material adverse effect on the value of our common stock.

*We are a holding company, and we could be unable in the future to obtain cash in amounts sufficient to service our financial obligations or meet our other commitments.* Our ability to meet our financial obligations and other contractual commitments depends upon our ability to access cash. We are a holding company, and our sources of cash include our available cash balances, net cash from the operating activities of our subsidiaries, any dividends and interest we may receive from our investments, availability under any credit facilities that we may obtain in the future and proceeds from any asset sales we may undertake in the future. The ability of our operating subsidiaries to pay dividends or to make other payments or advances to us depends on their individual operating results and any statutory, regulatory or contractual restrictions to which they may be or may become subject.

*We do not have access to the cash that Discovery generates from its operating activities.* Discovery generated approximately \$480 million, \$69 million and \$125 million of cash from its operations during the years ended December 31, 2006, 2005 and 2004, respectively. Discovery uses the cash it generates from its operations to fund its investing activities and to service its debt and other financing obligations. We do not have access to the cash that Discovery generates unless Discovery declares a dividend on its capital stock payable in cash, redeems any or all of its outstanding shares of capital stock for cash or otherwise distributes or makes payments to its stockholders, including us. Historically, Discovery has not paid any dividends on its capital stock or, with limited exceptions, otherwise distributed cash to its stockholders and instead has used all of its available cash in the expansion of its business and to service its debt obligations. Covenants in Discovery's existing debt instruments also restrict the payment of dividends and cash distributions to stockholders. We expect that Discovery will continue to apply its available cash to the expansion of its business. We do not have sufficient voting control to cause Discovery to pay dividends or make other payments or advances to its stockholders, or otherwise provide us access to Discovery's cash.

*We have limited operating history as a separate company upon which you can evaluate our performance.* Although our subsidiary Ascent Media was a separate public company prior to June 2003 (when Liberty acquired the outstanding shares of Ascent Media that it did not already own), we have limited operating history as a separate public company. Additionally, the historical financial information included in this annual report for periods prior to our existence may not necessarily be representative of our results as a separate company. There can be no assurance that our business strategy will be successful on a long-term basis. We may not be able to grow our businesses as planned and may not be profitable.

*We do not have the right to manage Discovery, which means we cannot cause Discovery to operate in a manner that is favorable to us.* Discovery is managed by its stockholders rather than a board of directors. Generally, all significant actions to be taken by Discovery require the approval of the holders of a majority of Discovery's shares; however, pursuant to a Stockholders' Agreement, the taking of certain actions (including, among other things, a merger of Discovery, or the issuance of additional shares of Discovery capital stock or approval of annual business plans) require the approval of the holders of at least 80% of Discovery's shares. Because we do not own a majority of the outstanding equity interests of Discovery, we do not have the right to manage the businesses or affairs of Discovery. Although our status as a 50% stockholder of Discovery enables us to exercise influence over the management and policies of Discovery, such status does not enable us to cause any actions to be taken. Cox Communications and Advance/Newhouse each hold a 25% interest in Discovery, which ownership interest enables each such company to prevent Discovery from taking actions requiring 80% approval.

Actions to be taken by Discovery that require the approval of a majority of Discovery's shares may, under certain circumstances, result in a deadlock. Because we own a 50% interest in Discovery and each of Cox Communications and Advance/Newhouse own a 25% interest in Discovery, a deadlock may occur when the stockholders vote to approve an action that requires majority approval. Accordingly, unless either Cox Communications or Advance/Newhouse elects to vote with us on items that require majority action, such actions may not be taken. Pursuant to the terms of the Stockholders' Agreement, if an action that requires approval by a majority of Discovery's shares is approved by 50%, but not more than 50%, of the outstanding shares then the proposed action will be submitted to an arbitrator designated by the stockholders. Currently, the arbitrator is John Hendricks, the founder and Chairman of Discovery. Mr. Hendricks, as arbitrator, is entitled to cast the deciding vote on matters where the stockholders have deadlocked because neither side has a majority. Mr. Hendricks, however, is not obligated to take action to break such a deadlock. In addition, Mr. Hendricks may elect to approve actions we have opposed, if such a deadlock exists. In the event of a dispute among the stockholders of Discovery, the possibility of such a deadlock could have a material adverse effect on Discovery's business.

*The liquidity and value of our interest in Discovery may be adversely affected by a Stockholders' Agreement to which we are a party.* Our 50% interest in Discovery is subject to the terms of a Stockholders' Agreement among the holders of Discovery capital stock. Among other things, the Stockholders' Agreement restricts our ability to directly sell or transfer our interest in Discovery or to borrow against its value. These restrictions impair the liquidity of our interest in Discovery and may make it difficult for us to obtain full value for our interest in Discovery should such a need arise. In the event we chose to sell all or a portion of our direct interest in Discovery, we would first have to obtain an offer from an unaffiliated third party and then offer to sell such interest to Cox Communications and Advance/Newhouse on substantially the same terms as the third party had agreed to pay.

If either Cox Communications or Advance/Newhouse decided to sell their respective interests in Discovery, then the other of such two stockholders would have a right to acquire such interests on the terms set by a third party offer obtained by the selling stockholder. If the non-selling stockholder elects not to exercise this acquisition right, then, subject to the terms of the Stockholders' Agreement, we would have the opportunity to acquire such interests on substantially the terms set by a third party offer obtained by the selling stockholder. We anticipate that the purchase price to acquire the interests held by Cox Communications or Advance/Newhouse would be significant and could require us to obtain significant funding in order to raise sufficient funds to purchase one or both of their interests. This opportunity to purchase the Discovery interests held by Cox Communications and/or Advance/Newhouse may arise (if at all) at a time when it would be difficult for us to raise the funds necessary to purchase such interests.

We do not have the ability to require Cox Communications or Advance/Newhouse to sell their interests in Discovery to us, nor do they have the ability to require us to sell our interest to them. Accordingly, the current governance relationships affecting Discovery may continue indefinitely.

*Because we do not control the business management practices of Discovery, we rely on Discovery for the financial information that we use in accounting for our ownership interest in Discovery.* We account for our 50% ownership interest in Discovery using the equity method of accounting and, accordingly, in our financial statements we record our share of Discovery's net income or loss. Because we do not control Discovery's decision-making process or business management practices, within the meaning of U.S. accounting rules, we rely on Discovery to provide us with financial information prepared in accordance with generally accepted accounting principles, which we use in the application of the

equity method. We have entered into an agreement with Discovery regarding the use by us of certain information regarding Discovery in connection with our financial reporting and disclosure requirements as a public company. However, such agreement limits the public disclosure by us of certain non-public information regarding Discovery (other than specified historical financial information), and also restricts our ability to enforce the agreement against Discovery with a lawsuit seeking monetary damages, in the absence of gross negligence, reckless conduct or willful misconduct on the part of Discovery. In addition, we cannot change the way in which Discovery reports its financial results or require Discovery to change its internal controls over financial reporting.

*We cannot be certain that we will be successful in integrating acquired businesses, if any.* Our businesses and those of our subsidiaries may grow through acquisitions in selected markets. Integration of new businesses may present significant challenges, including: realizing economies of scale in programming and network operations; eliminating duplicative overheads; and integrating networks, financial systems and operational systems. We or the applicable subsidiary cannot assure you that, with respect to any acquisition, we will realize anticipated benefits or successfully integrate any acquired business with our existing operations. In addition, while we intend to implement appropriate controls and procedures as we integrate acquired companies, we may not be able to certify as to the effectiveness of these companies' disclosure controls and procedures or internal control over financial reporting (as required by U.S. federal securities laws and regulations) until we have fully integrated them.

*A loss of any of Ascent Media's large customers would reduce our revenue.* Although Ascent Media serviced over 3,800 customers during the year ended December 31, 2006, its ten largest customers accounted for approximately 48% of its consolidated revenue and Ascent Media's single largest customer accounted for approximately 8% of its consolidated revenue during that period. The loss of, and the failure to replace, any significant portion of the services provided to any significant customer could have a material adverse effect on the business of Ascent Media.

*Ascent Media's business depends on certain client industries.* Ascent Media derives much of its revenue from services provided to the motion picture and television production industries and from the data transmission industry. Fundamental changes in the business practices of any of these client industries could cause a material reduction in demand by Ascent Media's clients for the services offered by Ascent Media. Ascent Media's business benefits from the volume of motion picture and television content being created and distributed as well as the success or popularity of an individual television show. Accordingly, a decrease in either the supply of, or demand for, original entertainment content would have a material adverse effect on Ascent Media's results of operations. Because spending for television advertising drives the production of new television programming, as well as the production of television commercials and the sale of existing content libraries for syndication, a reduction in television advertising spending would adversely affect Ascent Media's business. Factors that could impact television advertising and the general demand for original entertainment content include the growing use of personal video recorders and video-on-demand services, continued fragmentation of and competition for the attention of television audiences, and general economic conditions.

*Changes in technology may limit the competitiveness of and demand for our services.* The post-production industry is characterized by technological change, evolving customer needs and emerging technical standards, and the data transmission industry is currently saturated with companies providing services similar to Ascent Media's. Historically, Ascent Media has expended significant amounts of capital to obtain equipment using the latest technology. Obtaining access to any new technologies that may be developed in Ascent Media's industries will require additional capital expenditures, which may be significant and may have to be incurred in advance of any revenue that may be generated by such new technologies. In addition, the use of some technologies may require third party licenses, which may not be available on commercially reasonable terms. Although we believe that Ascent Media will be able to continue to offer services based on the newest technologies, we cannot assure you that Ascent Media will be able to obtain any of these technologies, that Ascent Media will be able to effectively implement these technologies on a cost-effective or timely basis or that such technologies will not render obsolete Ascent Media's role as a provider of motion picture and television production services. If Ascent Media's competitors in the data transmission industry have technology that enables them to provide services that are more reliable, faster, less expensive, reach more customers or have other advantages over the data transmission services Ascent Media provides, then the demand for Ascent Media's data transmission services may decrease.

Technology in the video, telecommunications and data services industry is changing rapidly. Advances in technologies such as personal video recorders and video-on-demand and changes in television viewing habits facilitated by these or other technologies could have an adverse effect on Discovery's advertising revenue and viewership levels. The ability to anticipate changes in, and adapt to, changes in technology and consumer tastes on a timely basis and exploit new sources of revenue from these changes will affect the ability of Discovery to continue to grow, increase its revenue and number of subscribers and remain competitive.

*A labor dispute in our client industries may disrupt our business.* The cost of producing and distributing entertainment programming has increased substantially in recent years due to, among other things, the increasing demands of creative talent and industry-wide collective bargaining agreements.

A significant labor dispute in Ascent Media's client industries could have a material adverse effect on its business. An industry-wide strike or other job action by or affecting the Writers Guild, Screen Actors Guild or other major entertainment industry union could reduce the supply of original entertainment content, which would in turn, reduce the demand for Ascent Media's services.

Discovery airs certain entertainment programs that are dependent on specific on-air talent, and Discovery's ability to continue to produce these series is dependent on keeping that on-air talent under contract.

*Risk of loss from earthquakes or other catastrophic events could disrupt Ascent Media's business.* Some of Ascent Media's specially equipped and acoustically designed facilities are located in Southern California, a region known for seismic activity. Due to the extensive amount of specialized equipment incorporated into the specially designed recording and scoring stages, editorial suites, mixing rooms and other post-production facilities, Ascent Media's operations in this region may not be able to be temporarily relocated to mitigate the impacts of a catastrophic event. Ascent Media carries insurance for property loss and business interruption resulting from such events, including earthquake insurance, subject to deductibles, and has facilities in other geographic locations. Although we believe Ascent Media has adequate insurance coverage relating to damage to its property and the temporary disruption of its business from casualties, and that it could provide services at other geographic locations, there can be no assurance that such insurance and other facilities would be sufficient to cover all of Ascent Media's costs or damages or Ascent Media's loss of income resulting from its inability to provide services in Southern California for an extended period of time.

*Discovery is dependent upon advertising revenue.* Discovery earns a significant portion of its revenue from the sale of advertising time on its networks and web sites. Discovery's advertising revenue is affected by viewer demographics, viewer ratings and market conditions for advertising. The overall cable and broadcast television industry is facing several issues with regard to its advertising revenue, including (1) audience fragmentation caused by the proliferation of other television networks, video-on-demand offerings from cable and satellite companies and broadband content offering, (2) the deployment of digital video recording devices, allowing consumers to time shift programming and skip or fast-forward through advertisements and (3) consolidation within the advertising industry, shifting more leverage to the bigger agencies and buying groups. Expenditures by advertisers tend to be cyclical, reflecting overall economic conditions as well as budgeting and buying patterns. A decline in the economic prospects of advertisers or the economy in general could alter current or prospective advertisers' spending priorities. In addition, the public's reception toward programs or programming genres can decline. An adverse change in any of these factors could have a negative effect on Discovery's revenue in any given period. Ascent Media's business is also dependent in part on the advertising industry, as a significant portion of Ascent Media's revenue is derived from the sale of services to agencies and/or the producers of television advertising.

*Discovery's revenue is dependent upon the maintenance of affiliation agreements with cable and satellite distributors on acceptable terms.* Discovery earns a significant portion of its revenue from per-subscriber license fees paid by cable operators, direct-to-home (DTH) satellite television operators and other channel distributors. Discovery's networks maintain affiliation arrangements that enable them to reach a large percentage of cable and direct broadcast satellite households across the United States, Asia, Europe and Latin America. These arrangements are generally long-term arrangements ranging from 3 to 10 years. These affiliation arrangements usually provide for payment to Discovery based on the numbers of subscribers that receive the Discovery networks. Discovery's core networks depend on achieving and maintaining carriage within the most widely distributed cable programming tiers to maximize their subscriber base and revenue. The loss of a significant number of affiliation arrangements on basic programming tiers could reduce the distribution of Discovery's networks, thereby adversely affecting such networks' revenue from per-subscriber fees and their ability to sell advertising or the rates they are able to charge for such advertising. Those Discovery networks that are carried on digital tiers are dependent upon the continued upgrade of cable systems to digital capability and the public's continuing acceptance of, and willingness to pay for upgrades to, digital cable, as well as Discovery's ability to negotiate favorable carriage agreements on widely accepted digital tiers.

*Our businesses are subject to risks of adverse government regulation.* Programming services, satellite carriers, television stations and Internet and data transmission companies are subject to varying degrees of regulation in the United States by the Federal Communications Commission and other entities and in foreign countries by similar entities. Such regulation and legislation are subject to the political process and have been in constant flux over the past decade. Moreover, substantially every foreign country in which our subsidiaries or business affiliates have, or may in the future make, an investment regulates, in varying degrees, the distribution, content and ownership of programming services and foreign investment in programming companies. Further material changes in the law and regulatory requirements must be



anticipated, and there can be no assurance that our business and the business of our affiliates will not be adversely affected by future legislation, new regulation or deregulation.

*Failure to obtain renewal of FCC licenses could disrupt our business.* Ascent Media holds licenses, authorizations and registrations from the FCC required for the conduct of its network services business, including earth station and various classes of wireless licenses and an authorization to provide certain services. Most of the FCC licenses held by Ascent Media are for transmit/receive earth stations, which cannot be operated without individual licenses. The licenses for these stations are granted for a period of fifteen years and, while the FCC generally renews licenses for satellite earth stations routinely, there can be no assurance that Ascent Media's licenses will be renewed at their expiration dates. Registration with the FCC, rather than licensing, is required for receiving transmissions from satellites from points within the United States. Ascent Media relies on third party licenses or authorizations when it transmits domestic satellite traffic through earth stations operated by third parties. Our failure, and the failure of third parties, to obtain renewals of such FCC licenses could disrupt the network services segment of Ascent Media and have a material adverse effect on Ascent Media. Further material changes in the law and regulatory requirements must be anticipated, and there can be no assurance that our businesses will not be adversely affected by future legislation, new regulation, deregulation or court decisions.

*Our businesses operate in an increasingly competitive market, and there is a risk that our businesses may not be able to effectively compete with other providers in the future.* The entertainment and media services and programming businesses in which we compete are highly competitive and service-oriented. Ascent Media has few long-term or exclusive service agreements with its creative services customers. Business generation in these groups is based primarily on customer satisfaction with reliability, timeliness, quality and price. The major motion picture studios, which are Ascent Media's customers, such as Paramount Pictures, Sony Pictures Entertainment, Twentieth Century Fox, Universal Pictures, The Walt Disney Company, Metro-Goldwyn-Mayer and Warner Brothers, have the capability to perform similar services in-house. These studios also have substantially greater financial resources than Ascent Media's, and in some cases significant marketing advantages. Thus, depending on the in-house capacity available to some of these studios, a studio may be not only a customer but also a competitor. There are also numerous independent providers of services similar to Ascent Media's. Thomson, a French corporation, is also a major competitor of Ascent Media, particularly under its Technicolor brand, as is Kodak through its Laser Pacific division. We also actively compete with certain industry participants that have a unique operating niche or specialty business. If there were a significant decline in the number of motion pictures or the amount of original television programming produced, or if the studios or Ascent Media's other clients either established in-house post-production facilities or significantly expanded their in-house capabilities, Ascent Media's operations could be materially and adversely affected.

Discovery is primarily an entertainment and programming company that competes with other programming networks for viewers in general, as well as for viewers in special interest groups and specific demographic categories. In order to compete for these viewers, Discovery must obtain a regular supply of high quality category-specific programming. To the extent Discovery seeks third party suppliers of such programming, it competes with other cable and broadcast television networks for programming. The expanded availability of digital cable television and the introduction of direct-to-home satellite distribution has greatly increased the amount of channel capacity available for new programming networks, resulting in the launch of a number of new programming networks by Discovery and its competitors. This increase in channel capacity has also made competitive niche programming networks viable, because such networks do not need to reach the broadest possible group of viewers in order to be moderately successful.

Discovery's program offerings must also compete for viewers and advertisers with other entertainment media, such as home video, online activities and movies. Increasing audience fragmentation could have an adverse effect on Discovery's advertising and subscription revenue. In addition, the cable television and direct-to-home satellite industries have been undergoing a period of consolidation. As a result, the number of potential buyers of the programming services offered by Discovery is decreasing. In this more concentrated market, there can be no assurance that Discovery will be able to obtain or maintain carriage of its programming services by distributors when its current long-term contracts are up for renewal.

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*We have overlapping directors and management with Liberty and Liberty Global, Inc., which may lead to conflicting interests.* Five of our six executive officers also serve as executive officers of Liberty and one of our executive officers serves as an executive officer of Liberty Global, Inc., or LGI. LGI is an independent, publicly traded company, which was formed in connection with the business combination between UnitedGlobalCom, Inc. and Liberty Media International, Inc., or LMI. All of the shares of LMI were distributed by Liberty to its shareholders in June 2004. Our board of directors includes persons who are members of the board of directors of Liberty and/or LGI. We do not own any interest in Liberty or LGI, and to our knowledge Liberty and LGI do not own any interest in us. The executive officers and the members of our board of directors have fiduciary duties to our stockholders. Likewise, any such persons who serve in similar capacities at Liberty and/or LGI have fiduciary duties to such company's stockholders. Therefore, such persons may have

conflicts of interest or the appearance of conflicts of interest with respect to matters involving or affecting each company. For example, there may be the potential for a conflict of interest when we, Liberty or LGI look at acquisitions and other corporate opportunities that may be suitable for each of us. Moreover, most of our directors and officers continue to own Liberty and/or LGI stock and options to purchase Liberty and/or LGI stock. These ownership interests could create, or appear to create, potential conflicts of interest when these individuals are faced with decisions that could have different implications for our company and Liberty or LGI. On June 1, 2005, the board of directors of Liberty adopted a policy statement that, subject to certain qualifications, including the fiduciary duties of Liberty's board of directors, Liberty will use its commercially reasonable efforts to make available to us any corporate opportunity relating to the acquisition of all or substantially all of the assets of, or equity securities representing "control" (as defined in the policy statement) of, any entity whose primary business is the acquisition, creation and/or distribution of television programming consisting primarily of science and nature programming for distribution primarily in the "basic" service provided by cable and satellite television distributors. This policy statement of Liberty's board of directors can be amended, modified or rescinded by Liberty's board of directors in its sole discretion at any time, and the policy automatically terminates without any further action of the board of directors of Liberty on the second anniversary of the distribution date. From time to time, Liberty or LGI or their respective affiliates may enter into transactions with us or our subsidiaries or other affiliates. Although the terms of any such transactions will be established based upon negotiations between employees of the companies involved, there can be no assurance that the terms of any such transactions will be as favorable to us or our subsidiaries or affiliates as would be the case where the parties are completely at arms' length.

*We and Liberty or LGI may compete for business opportunities.* Liberty and LGI each own interests in various U.S. and international programming companies that have subsidiaries or controlled affiliates that own or operate domestic or foreign programming services that may compete with the programming services offered by our businesses. We have no rights in respect of U.S. or international programming opportunities developed by or presented to the subsidiaries or controlled affiliates of Liberty or LGI, and the pursuit of these opportunities by such subsidiaries or affiliates may adversely affect the interests of our company and its shareholders. In addition, a subsidiary of LGI operates a playout facility that competes with Ascent Media's London playout facility, and it is likely that other competitive situations will arise in the future. Because we, Liberty and LGI have some overlapping directors and officers, the pursuit of these opportunities may serve to intensify the conflicts of interest or appearance of conflicts of interest faced by our respective management teams. Our restated certificate of incorporation provides that no director or officer of ours will be liable to us or our stockholders for breach of any fiduciary duty by reason of the fact that any such individual directs a corporate opportunity to another person or entity (including LMI and LGI) instead of us, or does not refer or communicate information regarding such corporate opportunity to us, unless (x) such opportunity was expressly offered to such person solely in his or her capacity as a director or officer of our company or as a director or officer of any of our subsidiaries, and (y) such opportunity relates to a line of business in which our company or any of our subsidiaries is then directly engaged.

*It may be difficult for a third party to acquire us, even if doing so may be beneficial to our shareholders.* Certain provisions of our restated certificate of incorporation and bylaws may discourage, delay or prevent a change in control of our company that a shareholder may consider favorable. These provisions include the following:

- authorizing a capital structure with multiple series of common stock: a Series B that entitles the holders to ten votes per share, a Series A that entitles the holders to one vote per share and a Series C that, except as otherwise required by applicable law, entitles the holders to no voting rights;
- authorizing the issuance of "blank check" preferred stock, which could be issued by our board of directors to increase the number of outstanding shares and thwart a takeover attempt;
- classifying our board of directors with staggered three-year terms, which may lengthen the time required to gain control of our board of directors;
- limiting who may call special meetings of shareholders;
- prohibiting shareholder action by written consent (subject to certain exceptions), thereby requiring shareholder action to be taken at a meeting of the shareholders;
- establishing advance notice requirements for nominations of candidates for election to our board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;
- requiring shareholder approval by holders of at least 80% of our voting power or the approval by at least 75% of our board of directors with respect to certain extraordinary matters, such as a merger or consolidation of our company, a sale of all or substantially all of our assets or an amendment to our restated certificate of incorporation;
- requiring the consent of the holders of at least 75% of the outstanding Series B common stock (voting as a separate class) to certain share distributions and other corporate actions in which the voting power of the Series B common

stock would be diluted by, for example, issuing shares having multiple votes per share as a dividend to holders of Series A common stock; and

- the existence of authorized and unissued stock which would allow our board of directors to issue shares to persons friendly to current management, thereby protecting the continuity of its management, or which could be used to dilute the stock ownership of persons seeking to obtain control of us.

Our company has adopted a shareholder rights plan in order to encourage anyone seeking to acquire us to negotiate with our board of directors prior to attempting a takeover. While the plan is designed to guard against coercive or unfair tactics to gain control of us, the plan may have the effect of making more difficult or delaying any attempts by others to obtain control of us.

*Holders of any single series of our common stock may not have any remedies if any action by our directors or officers has an adverse effect on only that series of our common stock.* Principles of Delaware law and the provisions of our restated certificate of incorporation may protect decisions of our board of directors that have a disparate impact upon holders of any single series of our common stock. Under Delaware law, the board of directors has a duty to act with due care and in the best interests of all of our shareholders, including the holders of all series of our common stock. Principles of Delaware law established in cases involving differing treatment of multiple classes or series of stock provide that a board of directors owes an equal duty to all common shareholders regardless of class or series and does not have separate or additional duties to any group of shareholders. As a result, in some circumstances, our directors may be required to make a decision that is adverse to the holders of one series of our common stock. Under the principles of Delaware law referred to above, you may not be able to challenge these decisions if our board of directors is disinterested and adequately informed with respect to these decisions and acts in good faith and in the honest belief that it is acting in the best interests of all of our shareholders.

**Item 1B. Unresolved Staff Comments.**

None

**Item 2. Properties.**

We share our executive offices in Englewood, Colorado under a services agreement with Liberty. All of our other real or personal property is owned or leased by our subsidiaries or affiliates.

Ascent Media's operations are conducted at over 80 properties. In the United States, Ascent Media occupies owned and leased properties in California, Connecticut, Florida, Georgia, New Jersey, New York and Virginia; the network services group also operates a satellite earth station and related facilities in Minnesota. Internationally, Ascent Media has owned and leased properties in London, England. In addition, the creative services group operates a leased facility in Mexico City, Mexico, and has a 50% owned equity affiliate with facilities in Barcelona and Madrid, Spain, and the network services group operates two leased facilities in the Republic of Singapore. Worldwide, Ascent Media leases approximately 1.4 million square feet and owns another 325,000 square feet. In the United States, Ascent Media's leased properties total approximately 1.1 million square feet and have terms expiring between March 2007 and April 2015. Several of these agreements have extension options. The leased properties are used for our technical operations, office space and media storage. Ascent Media's international leases have terms that expire between March 2007 and September 2020, and are also used for technical operations, office space and media storage. Over half of the international leases have extension clauses. Approximately 250,000 square feet of Ascent Media's owned properties are located in Southern California, with another 45,000 square feet located in Northvale, New Jersey, Tappan, New York, Minneapolis, Minnesota and Stamford, Connecticut. In addition, Ascent Media owns approximately 30,000 square feet in London, England. Nearly all of Ascent Media's owned properties are purpose-built for its technical and creative service operations. Ascent Media's facilities are adequate to support its current near-term growth needs.

**Item 3. Legal Proceedings.**

The registrant and its subsidiaries are not a party to any material legal proceedings.

**Item 4. Submission of Matters to a Vote of Security Holders.**

None.

## PART II.

### **Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

#### **Market Information**

We have two series of common stock, Series A and Series B, which trade on the Nasdaq National Market under the symbols DISCA and DISCB, respectively. The following table sets forth the range of high and low sales prices of shares of our Series A and Series B common stock since our spin off on July 21, 2005.

	Series A		Series B	
	High	Low	High	Low
2006				
First quarter . . . . .	\$15.65	13.88	15.96	13.58
Second quarter . . . . .	\$15.18	13.61	15.21	13.73
Third quarter . . . . .	\$14.82	12.81	14.54	12.97
Fourth quarter . . . . .	\$16.96	14.18	16.85	13.97
2005				
July 21, 2005 through September 30, 2005 . . . . .	\$16.30	13.51	16.77	14.40
Fourth quarter . . . . .	\$16.23	13.69	16.80	13.59

#### **Holders**

As of February 6, 2007, there were approximately 84,000 and 700 record and beneficial holders of our Series A common stock and Series B common stock, respectively.

#### **Dividends**

We have not paid any cash dividends on our Series A common stock and Series B common stock, and we have no present intention of so doing. Payment of cash dividends, if any, in the future will be determined by our Board of Directors in light of our earnings, financial condition and other relevant considerations.

#### **Securities Authorized for Issuance Under Equity Compensation Plans**

Information required by this item is incorporated by reference to our definitive proxy statement for our 2007 Annual Meeting of shareholders.

### **Item 6. Selected Financial Data.**

Effective July 21, 2005, Liberty Media Corporation ("Liberty") completed a spin off transaction pursuant to which our capital stock was distributed as a dividend to holders of Liberty's Series A and Series B common stock. Subsequent to the spin off, we are a separate publicly traded company and we and Liberty operate independently. The spin off has been accounted for at historical cost due to the pro rata nature of the distribution. Accordingly, our historical financial statements are presented in a manner similar to a pooling of interest.

The following tables present selected historical information relating to our financial condition and results of operations for the past five years. The following data should be read in conjunction with our consolidated financial statements.

	December 31,				
	2006	2005	2004	2003	2002
	amounts in thousands				
Summary Balance Sheet Data:					
Investment in Discovery Communications, Inc. . . . .	\$3,129,157	3,018,622	2,945,782	2,863,003	2,816,513
Goodwill . . . . .	\$2,074,789	2,133,518	2,135,446	2,130,897	2,104,705
Total assets . . . . .	\$5,870,982	5,819,236	5,564,828	5,396,627	5,373,150
Stockholders' equity . . . . .	\$4,549,264	4,575,425	4,347,279	4,260,269	3,617,417

	Years ended December 31,				
	2006	2005	2004	2003	2002
	amounts in thousands, except per share amounts				
Summary Statement of Operations Data:					
Net revenue . . . . .	\$ 688,087	694,509	631,215	506,103	539,333
Operating income (loss)(1) . . . . .	\$(115,137)	(1,402)	16,935	(2,404)	(61,452)
Share of earnings (losses) of Discovery . . . . .	\$ 103,588	79,810	84,011	37,271	(32,046)
Net earnings (loss)(1) . . . . .	\$ (46,010)	33,276	66,108	(52,394)	(129,275)
Basic and diluted earnings (loss) per common share(2) . . . . .	\$ (0.16)	0.12	0.24	(0.19)	(0.46)

- (1) Includes impairment of goodwill and other long-lived assets of \$93,402,000 and \$83,718,000 for the years ended December 31, 2006 and 2002, respectively.
- (2) Basic and diluted net earnings (loss) per common share is based on (1) 280,199,000 shares, which is the number of shares issued in the spin off, for all periods prior to the spin off and (2) the actual number of weighted average outstanding shares for all periods subsequent to the spin off.

#### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion and analysis provides information concerning our results of operations and financial condition. This discussion should be read in conjunction with our accompanying consolidated financial statements and the notes thereto.

#### **Overview**

Effective July 21, 2005, Liberty completed a spin off transaction pursuant to which our capital stock was distributed as a dividend to holders of Liberty's Series A and Series B common stock. Subsequent to the spin off, we are a separate publicly traded company and we and Liberty operate independently. The spin off did not involve the payment of any consideration by the holders of Liberty common stock and was intended to qualify as a tax-free spin off. The spin off has been accounted for at historical cost due to the pro rata nature of the distribution. We are a holding company and our businesses and assets include Ascent Media Group, LLC ("Ascent Media"), which we consolidate, and a 50% ownership interest in Discovery Communications, Inc. ("Discovery" or "DCI"), which we account for using the equity method of accounting. Accordingly, as described below, Discovery's revenue is not reflected in the revenue we report in our financial statements. In addition to the foregoing assets, immediately prior to the spin off, Liberty transferred to a subsidiary of our company \$200 million in cash.

Ascent Media provides creative and network services to the media and entertainment industries. Ascent Media's clients include major motion picture studios, independent producers, broadcast networks, cable programming networks, advertising agencies and other companies that produce, own and/or distribute entertainment, news, sports, corporate, educational, industrial and advertising content. Subsequent to an operational realignment in 2006, Ascent Media's operations are organized into the following three groups: Creative services, Network services and Corporate and other. Ascent Media has few long-term or exclusive agreements with its creative services customers.

In 2007, Ascent Media will continue to focus on leveraging its broad array of media services to market itself as a full service provider to new and existing customers within the feature film and television production industry. Ascent Media also believes it can optimize its position in the market by growing its digital media management business. With facilities in the U.S., the United Kingdom, Asia and Mexico, Ascent Media hopes to increase its services to multinational companies. The challenges that Ascent Media faces include differentiating its products and services to help maintain or increase operating margins and financing capital expenditures for equipment and other items to satisfy customers' desire for services using the latest technology.

Our most significant asset is Discovery, in which we do not have a controlling financial interest. Discovery is a global media and entertainment company that provides original and purchased video programming in the United States and over 170 other countries. We account for our 50% ownership interest in Discovery using the equity method of accounting. Accordingly, our share of the results of operations of Discovery is reflected in our consolidated results as earnings or losses of Discovery. To assist the reader in better understanding and analyzing our business, we have included a separate discussion and analysis of Discovery's results of operations and financial condition below.

## Acquisitions

*AccentHealth.* Effective January 27, 2006, one of our subsidiaries acquired substantially all of the assets of AccentHealth, LLC's ("AccentHealth") healthcare media business for cash consideration of \$46,793,000. AccentHealth operates an advertising-supported captive audience television network in doctor office waiting rooms nationwide. For financial reporting purposes, the acquisition is deemed to have occurred on February 1, 2006, and the results of operations of AccentHealth have been included in our consolidated results as part of the network services group since the date of acquisition.

*Cinetech.* On October 20, 2004, Ascent Media acquired substantially all of the assets of Cinetech, Inc., a film laboratory and still image preservation and restoration company, for \$10,000,000 in cash plus contingent compensation of up to \$1,500,000 to be paid based on the satisfaction of certain contingencies as set forth in the purchase agreement. Cinetech is included in Ascent Media's creative services group.

*London Payout Centre.* On March 12, 2004, Ascent Media acquired the entire issued share capital of London Payout Centre Limited, for a cash purchase price of \$36,573,000. London Payout Centre, which we refer to as LPC, is a UK-based television channel origination facility. LPC is included in Ascent Media's network services group.

## Operating Cash Flow

We evaluate the performance of our operating segments based on financial measures such as revenue and operating cash flow. We define operating cash flow as revenue less cost of services and selling, general and administrative expense (excluding stock and other equity-based compensation and accretion expense on asset retirement obligations). We believe this is an important indicator of the operational strength and performance of our businesses, including the ability to invest in ongoing capital expenditures and service any debt. In addition, this measure allows management to view operating results and perform analytical comparisons and identify strategies to improve performance. This measure of performance excludes depreciation and amortization, stock and other equity-based compensation, accretion expense on asset retirement obligations, restructuring and impairment charges that are included in the measurement of operating income pursuant to U.S. generally accepted accounting principles, or GAAP. Accordingly, operating cash flow should be considered in addition to, but not as a substitute for, operating income, cash flow provided by operating activities and other measures of financial performance prepared in accordance with GAAP. See note 17 to the accompanying consolidated financial statements for a reconciliation of operating cash flow to earnings (loss) before income taxes.

## Results of Operations

Our consolidated results of operations include general and administrative expenses incurred at the DHC corporate level, 100% of Ascent Media's and AccentHealth's results and our 50% share of earnings of Discovery.

Ascent Media's creative services group revenue is primarily generated from fees for video and audio post production, special effects and editorial services for the television, feature film and advertising industries. Generally, these services pertain to the completion of feature films, television programs and advertisements. These projects normally span from a few days to three months or more in length, and fees for these projects typically range from \$10,000 to \$1,000,000 per project. Additionally, the creative services group provides owners of film libraries a broad range of restoration, preservation, archiving, professional mastering and duplication services. The scope of these creative services vary in duration from one day to several months depending on the nature of the service, and fees typically range from less than \$1,000 to \$100,000 per project. The creative services group includes Ascent Media's digital media center which is developing new products and businesses in areas such as digital imaging, digital media and interactive media.

The network services group's revenue consists of fees relating to facilities and services necessary to assemble and transport programming for cable and broadcast networks across the world via fiber, satellite and the Internet. The group's revenues are also driven by systems integration and field support services, technology consulting services, design and implementation of advanced video systems, engineering project management, technical help desk and field service. Approximately 60% of the network services group's revenue relates to broadcast services, satellite operations and fiber services that are earned monthly under long-term contracts ranging generally from one to seven years. Additionally, approximately 40% of revenue relates to systems integration and engineering services that are provided on a project basis over terms generally ranging from three to twelve months.

Corporate related items and expenses are reflected in Corporate and other, below. Cost of services and operating expenses consists primarily of production wages, facility costs and other direct costs and selling, general and administrative expenses.

Our consolidated results of operations for the year ended December 31, 2006 include approximately eleven months of results for AccentHealth. The consolidated results of operations for the year ended December 31, 2004 include approximately nine months of results for LPC and approximately two months of results for Cinetech.

	Years ended December 31,		
	2006	2005	2004
	amounts in thousands		
<b>Segment Revenue</b>			
Creative Services group	\$417,876	421,797	405,026
Network Services group	270,211	272,712	226,189
Corporate and other	—	—	—
	<u>\$688,087</u>	<u>694,509</u>	<u>631,215</u>
<b>Segment Operating Cash Flow</b>			
Creative Services group	\$ 52,554	70,708	72,903
Network Services group	49,522	55,877	62,537
Corporate and other	(43,347)	(47,960)	(37,645)
	<u>\$ 58,729</u>	<u>78,625</u>	<u>97,795</u>

**Revenue.** Our total revenue decreased 0.9% and increased 10.0% for the years ended December 31, 2006 and 2005, respectively, as compared to the corresponding prior year. In 2006, creative services group revenue decreased \$3,921,000 as a result of (i) an \$8,400,000 decline in media services due to lower traditional media and DVD services from major studios partially offset by continued growth in new digital services and (ii) lower television revenue of \$2,165,000 driven by declines in the U.K. broadcast work, partially offset by higher television audio and post services in the U.S. These creative services revenue decreases were partially offset by a \$6,535,000 increase in commercial services, driven primarily by strong U.S. demand, and higher feature revenue of \$1,770,000, driven by an increased number of titles for post production services, partially offset by smaller size feature sound projects and lower home theatre. Network services group's 2006 revenue decreased \$2,501,000 as a result of (i) a decline in systems integration and services revenue of \$11,080,000, reflecting significant one-time projects in 2005 and (ii) lower revenue in the U.K. of \$15,060,000, primarily as a result of termination of content distribution contracts. These network services revenue decreases were partially offset by the acquisition of AccentHealth in 2006, which generated \$20,873,000 of revenue, and by increased content distribution activity in the U.S. and Singapore.

In 2005, creative services group revenue increased \$16,771,000 as a result of a \$7,330,000 increase in commercial revenue, primarily in the U.S., a \$4,660,000 increase due to strong sales of U.S. television services from an increased number of shows, and \$9,906,000 of higher lab revenue driven by the acquisition of Cinetech. These increases were offset by declining sound services revenue of \$2,960,000 resulting from lower sales of services for features and games and lower media services volumes of \$2,470,000 from traditional services, subtitling and DVD, partially offset by higher digital services. Network services group's 2005 revenue increased \$46,523,000 due to \$9,423,000 of revenue related to the LPC acquisition, \$33,634,000 from a higher number of large engineering and systems integration projects and \$13,083,000 of higher origination business revenue and other new initiatives, partially offset by the \$9,550,000 effect of lower renewal rates on certain ongoing broadcast services contracts.

**Cost of Services.** Our cost of services increased 1.9% and 17.2% for the years ended December 31, 2006 and 2005, respectively, as compared to the corresponding prior year. In 2006, the increase in cost of services is driven by the AccentHealth acquisition which contributed costs of \$6,439,000 and by changes in foreign currency exchange rates of \$1,367,000. The 2005 increase is partially attributable to the 2004 acquisitions discussed above, which contributed \$12,109,000 in cost of services. In addition, cost of services increased in 2005 due to a change in revenue mix driven by higher systems engineering and integration projects in the network services group which have higher production and engineering labor and production material and equipment costs.

As a percent of revenue, cost of services was 66.1%, 64.2% and 60.2% for the years ended December 31, 2006, 2005 and 2004, respectively. The increase in each year is driven by increases in labor costs partially offset by decreases in materials cost. Labor costs have increased as the revenue mix moves toward more labor intensive feature services and as projects have become increasingly more integrated, with complex work flows requiring higher levels of production labor and project management.

**Selling, General and Administrative.** Our selling, general and administrative expenses ("SG&A"), (excluding stock-based compensation and accretion expense on asset retirement obligations), increased 2.8% and 11.0% for the years

ended December 31, 2006 and 2005, respectively, as compared to the corresponding prior year. For 2006, the acquisition of AccentHealth added \$6,565,000 of SG&A expense, slightly offset by lower personnel costs and professional fees. The 2005 increase in SG&A expense is primarily attributable to the impact of the 2004 acquisitions of \$5,270,000 and the growth in 2005 revenue driving higher labor, facility and selling expenses. As a percent of revenue, SG&A increased from 24.5% to 25.4% for the years ended December 31, 2005 and 2006, respectively, due to the acquisition of AccentHealth in 2006, combined with a slight overall decline in revenue.

Corporate and other operating cash flow improved \$4,613,000 in 2006 primarily due to lower Ascent Media corporate expenses, partially offset by an increase in DHC corporate, general and administrative expenses which were \$9,360,000 and \$6,467,000 for the years ended December 31, 2006 and 2005, respectively. The 2005 decrease in operating cash flow of \$10,315,000 is due to DHC corporate expenses, which primarily relate to the Spin Off (\$5,072,000) and charges pursuant to the services agreement with Liberty subsequent to the Spin Off (\$876,000), and to higher Ascent Media corporate expenses (\$3,848,000) as a result of higher labor, facility, and professional services costs related to reengineering of corporate departments and processes and to a legal settlement.

*Depreciation and Amortization.* The decrease in depreciation and amortization expense from 2005 to 2006 is due to assets becoming fully depreciated partially offset by capital expenditures and the AccentHealth acquisition. Depreciation and amortization were comparable in 2005 and 2004.

*Stock Compensation.* Stock-based compensation was \$1,817,000, \$4,383,000 and \$2,775,000 for the years ended December 31, 2006, 2005 and 2004, respectively, and is included in SG&A in the Consolidated Statements of Operations and Comprehensive Earnings (Loss). Effective January 1, 2006, we adopted Statement No. 123R. Statement No. 123R requires that we amortize the grant date fair value of our stock option and SAR Awards that qualify as equity awards as stock compensation expense over the vesting period of such Awards. Statement No. 123R also requires that we record our liability awards at fair value each reporting period and that the change in fair value be reflected as stock compensation expense in our consolidated statement of operations. Prior to adoption of Statement No. 123R, the amount of expense associated with stock-based compensation was generally based on the vesting of the related stock options and stock appreciation rights and the market price of the underlying common stock. The expense reflected in our consolidated financial statements was based on the market price of the underlying common stock as of the date of the financial statements.

In 2001, Ascent Media granted to certain of its officers and employees stock options (the "Ascent Media Options") with exercise prices that were less than the market price of Ascent Media common stock on the date of grant. The Ascent Media Options became exercisable for Liberty shares in connection with Liberty's acquisition in 2003 of the Ascent Media shares that it did not already own. Prior to January 1, 2006, we amortized the "in-the-money" value of these options over the 5-year vesting period. Certain Ascent Media employees also hold options and stock appreciation rights granted by companies acquired by Ascent Media in the past several years and exchanged for Liberty options and SARs. Prior to January 1, 2006 we recorded compensation expense for the SARs based on the underlying stock price and vesting of such awards.

On May 24, 2005, Liberty commenced an offer to purchase certain stock options and SARs held by eligible employees of Ascent Media. The offer to purchase related to 1,173,028 options and SARs, and the aggregate offering price for such options and SARs was approximately \$2.15 million. The offer to purchase expired at 9:00 p.m., Pacific time, on June 21, 2005. Eligible employees tendered options with respect to 1,121,673 shares of Liberty Series A common stock, and Liberty purchased such options for aggregate cash payments of approximately \$2.14 million. In connection with these purchases, Ascent Media recorded 2005 compensation expense of \$3,830,000, which included (1) the amount of the cash payments less any previously accrued compensation for the SARs, (2) the previously unamortized in-the-money value related to the Ascent Media Options and (3) ongoing amortization of the unexercised Ascent Media options.

As of December 31, 2006, the total compensation cost related to unvested equity awards was \$1.1 million. Such amount will be recognized in our consolidated statements of operations through 2009.

*Restructuring Charges.* On August 18, 2006, Ascent Media announced that it intended to streamline its structure into two global operating divisions — creative services group and network services group — to better align Ascent Media's organization with the company's strategic goals and to respond to changes within the industry driven by technology and customer requirements (the "2006 Restructuring"). The operations of the media management services group were realigned with the other two groups, which was completed in the fourth quarter of 2006. As a result of the realignment, Ascent Media recorded a restructuring charge of \$12,092,000 during the year ended December 31, 2006, primarily related to severance. These restructuring activities were primarily in the Corporate and other group in the United States and United Kingdom.



During the year ended December 31, 2005, Ascent Media recorded a restructuring charge of \$4,112,000 related to the consolidation of certain operating facilities resulting in excess leased space, consolidation expenses and severance from reductions in headcount. These restructuring activities were implemented to improve ongoing operating efficiencies and effectiveness primarily in the creative services group in the U.K. There was no restructuring charge in 2004.

*Impairment of Goodwill* As a result of the 2006 Restructuring and the declining financial performance of the media management services group, including ongoing operating losses driven by technology and customer requirement changes in the industry, the media management services group was tested for goodwill impairment in the third quarter of 2006, prior to DHC's annual goodwill valuation assessment of the entire company. DHC estimated the fair value of that reporting unit principally by using trading multiples of revenue and operating cash flows of similar companies in the industry. This test resulted in a goodwill impairment loss for the media management services group of \$93,402,000, which represents the excess of the carrying value over the implied fair value of such goodwill.

*Share of Earnings of Discovery* Our share of earnings of Discovery increased \$23,778,000 or 29.8% in 2006 and decreased \$4,201,000 or 5.0% in 2005. The 2006 increase is due to Discovery's higher operating income partially offset by higher interest expense and the change in minority interests in consolidated subsidiaries. Discovery's net income decreased in 2005 as increases in revenue and operating income were more than offset by increases in interest expense and income tax expense.

For a more detailed discussion of Discovery's results of operations, see "—Management's Discussion and Analysis of Financial Condition and Results of Operations of Discovery."

*Income Taxes* For the year ended December 31, 2006, we recorded income tax expense of \$43,942,000, but had a loss before taxes of \$2,068,000. The pre-tax loss resulted primarily from a \$93,402,000 goodwill impairment charge recorded in the third quarter of 2006, for which we received no tax benefit. Our effective tax rate was 59.5% and 34.6% for the years ended December 31, 2005 and 2004, respectively. While we were a subsidiary of Liberty, we calculated our deferred tax liabilities using Liberty's blended weighted average state tax rate. Subsequent to our spin off, we assessed such rate in light of the fact that we are located primarily in California, which has a higher state income tax rate than many of the other states in which Liberty does business, and we determined that our effective tax rate should be increased from 39% to 39.55%. This increase resulted in additional deferred tax expense in 2005 of \$15,263,000. Our income tax rate in 2005 was higher than the federal income tax rate of 35% due to state and foreign tax expense.

*Net Earnings (Loss)* We recorded net earnings (loss) of (\$46,010,000), \$33,276,000 and \$66,108,000 for the years ended December 31, 2006, 2005 and 2004, respectively. The change between each of these years is discussed in the aforementioned fluctuations in revenue and expenses.

## Liquidity and Capital Resources

For the year ended December 31, 2006, our primary uses of cash were capital expenditures (\$77,541,000) and acquisitions (\$46,793,000). We funded these investing activities with cash from operating activities of \$73,633,000 and with our available cash. Of the foregoing 2006 capital expenditures, \$20,316,000 relates to the buildout of Ascent Media's existing facilities for customer specific contracts. The remainder of our capital expenditures relates to purchases of new equipment and the upgrade of existing facilities and equipment. For the foreseeable future, we expect to have sufficient available cash balances and net cash from operating activities to meet our working capital needs and capital expenditure requirements. We intend to seek external equity or debt financing in the event any new investment opportunities, additional capital expenditures or our operations require additional funds, but there can be no assurance that we will be able to obtain equity or debt financing on terms that are acceptable to us.

In 2007, Ascent Media and AccentHealth expect to spend approximately \$60,000,000 for capital expenditures, which we expect will be funded with their cash from operations and cash on hand.

Our ability to seek additional sources of funding depends on our future financial position and results of operations, which, to a certain extent, are subject to general conditions in or affecting our industry and our customers and to general economic, political, financial, competitive, legislative and regulatory factors beyond our control.

We do not have access to the cash Discovery generates from its operations, unless Discovery pays a dividend on its capital stock or otherwise distributes cash to its stockholders. Historically, Discovery has not paid any dividends on its capital stock and we do not have sufficient voting control to cause Discovery to pay dividends or make other payments or advances to us.

## Off-Balance Sheet Arrangements and Contractual Obligations

Information concerning the amount and timing of required payments under our contractual obligations at December 31, 2006 is summarized below:

Payments due by period	Amounts in thousands			
	Less than 1 year	1-3 years	4-5 years	After 5 years
Operating leases	\$32,058	56,801	44,026	59,144
Other	—	6,100	—	—
Total contractual obligations	\$32,058	62,901	44,026	59,144
				198,129

We have contingent liabilities related to legal proceedings and other matters arising in the ordinary course of business. Although it is reasonably possible we may incur losses upon conclusion of such matters, an estimate of any loss or range of loss cannot be made. In the opinion of management, it is expected that amounts, if any, which may be required to satisfy such contingencies will not be material in relation to the accompanying consolidated financial statements.

## Recent Accounting Pronouncements

The Financial Accounting Standards Board ("FASB") has issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109" ("FIN 48"), regarding accounting for, and disclosure of, uncertain tax positions. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are in the process of evaluating the potential impact of the adoption of FIN 48 on our consolidated balance sheet and statements of operations and comprehensive earnings (loss), and do not believe this adoption will have a material impact.

## Critical Accounting Estimates

**Valuation of Long-lived Assets and Amortizable Other Intangible Assets.** We perform impairment tests for our long-lived assets if an event or circumstance indicates that the carrying amount of our long-lived assets may not be recoverable. In response to changes in industry and market conditions, we may also strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses. Such activities could result in impairment of our long-lived assets or other intangible assets. We are subject to the possibility of impairment of long-lived assets arising in the ordinary course of business. We regularly consider the likelihood of impairment and recognize impairment if the carrying amount of a long-lived asset or intangible asset is not recoverable from its undiscounted cash flows in accordance with SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets". Impairment is measured as the difference between the carrying amount and the fair value of the asset. We use both the income approach and market approach to estimate fair value. Our estimates of fair value are subject to a high degree of judgment. Accordingly, any value ultimately derived from our long-lived assets may differ from our estimate of fair value.

**Valuation of Goodwill and Non-amortizable Other Intangible Assets.** We assess the impairment of goodwill annually and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include significant underperformance to historical or projected future operating results, substantial changes in our strategy or the manner of use of our assets, and significant negative industry or economic trends. Fair value of each reporting unit is determined through the use of an outside independent valuation consultant. Both the income approach and market approach are used in determining fair value.

**Valuation of Trade Receivables.** We must make estimates of the collectibility of our trade receivables. Our management analyzes the collectibility based on historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms. We record an allowance for doubtful accounts based upon specifically identified receivables that we believe are uncollectible. In addition, we also record an amount based upon a percentage of each aged category of our trade receivables. These percentages are estimated based upon our historical experience of bad debts. Our trade receivables balance was \$156,481,000, net of allowance for doubtful accounts of \$9,045,000, as of December 31, 2006.

*Valuation of Deferred Tax Assets.* In accordance with SFAS No. 109, "Accounting for Income Taxes", we review the nature of each component of our deferred income taxes for reasonableness. We have determined that it is more likely than not that we will not realize the tax benefits associated with certain cumulative net operating loss carry forwards and impairment reserves, and as such, we have established a valuation allowance of \$96,223,000 and \$91,235,000 as of December 31, 2006 and 2005, respectively.

#### Discovery

We hold a 50% ownership interest in Discovery and account for this investment using the equity method of accounting. Accordingly, in our financial statements we record our share of Discovery's net income or loss available to common shareholders and reflect this activity in one line item in the statement of operations as "Share of earnings of Discovery." The following financial information of Discovery for the years ended December 31, 2006, 2005 and 2004 and related discussion is presented to provide the reader with additional analysis of the operating results and financial position of Discovery. Because we do not control the decision-making process or business management practices of Discovery, we rely on Discovery to provide us with financial information prepared in accordance with GAAP that we use in the application of the equity method. The information included in this section should be read in conjunction with the audited financial statements of Discovery for the year ended December 31, 2006 included elsewhere herein. The following discussion and analysis of Discovery's operations and financial position has been prepared based on information that we receive from Discovery and represents our views and understanding of their operating performance and financial position based on such information. Discovery is not a separately traded public company, and we do not have the ability to cause Discovery's management to prepare their own management's discussion and analysis for our purposes. Accordingly, we note that the material presented in this section might be different if Discovery's management had prepared it.

The following discussion of Discovery's results of operations is presented on a consolidated basis. In order to provide a better understanding of Discovery's operations, we have also included a summarized presentation of revenue and operating cash flow of Discovery's three operating groups: Discovery networks U.S., or U.S. networks, Discovery networks international, or international networks, and Discovery commerce, education & other.

The U.S. networks is Discovery's largest division. It owns and operates 12 cable and satellite channels and provides distribution and advertising sales services for BBC America and distribution services for BBC World News. International networks manages a portfolio of channels, led by the Discovery Channel and Animal Planet brands, that is distributed in virtually every pay-television market in the world via an infrastructure that includes major operational centers in London, Singapore, New Delhi and Miami. Discovery commerce, education & other includes Discovery's retail chain store operations and other direct consumer marketing activities, as well as Discovery education, which manages Discovery's distribution of education content to schools and consumers.

### Consolidated Results of Discovery

	Years ended December 31,		
	2006	2005	2004
	amounts in thousands		
<b>Revenue</b>			
Advertising .....	\$ 1,243,500	1,187,823	1,133,807
Distribution .....	1,434,901	1,198,686	976,362
Other .....	334,587	285,245	255,177
Total revenue .....	<u>3,012,988</u>	<u>2,671,754</u>	<u>2,365,346</u>
<b>Expenses</b>			
Cost of revenue .....	(1,120,377)	(979,765)	(846,316)
SG&A expense .....	(1,170,187)	(1,005,351)	(856,340)
Operating cash flow .....	<u>722,424</u>	<u>686,638</u>	<u>662,690</u>
Expenses arising from long-term incentive plans .....	(39,233)	(49,465)	(71,515)
Depreciation & amortization .....	(133,634)	(123,209)	(129,011)
Gain on sale of patents .....	—	—	22,007
Operating income .....	<u>549,557</u>	<u>513,964</u>	<u>484,171</u>
<b>Other Income (Expense)</b>			
Interest expense, net .....	(194,227)	(184,575)	(167,420)
Realized and unrealized gains from derivative instruments, net .....	22,558	22,499	45,540
Minority interests in consolidated subsidiaries .....	(2,451)	(43,696)	(54,940)
Other .....	8,527	13,771	2,470
Income before income taxes .....	383,964	321,963	309,821
Income tax expense .....	(176,788)	(162,343)	(141,799)
Net income .....	<u>\$ 207,176</u>	<u>159,620</u>	<u>168,022</u>

### Business Segment Results of Discovery

	Years ended December 31,		
	2006	2005	2004
	amounts in thousands		
<b>Revenue</b>			
U.S. networks .....	\$1,926,180	1,743,358	1,599,678
International networks .....	879,074	738,094	596,450
Discovery commerce, education & other .....	207,734	190,302	169,218
Total revenue .....	<u>\$3,012,988</u>	<u>2,671,754</u>	<u>2,365,346</u>
<b>Operating Cash Flow</b>			
U.S. networks .....	\$ 727,469	643,366	597,922
International networks .....	116,446	107,096	101,875
Discovery commerce, education & other .....	(121,491)	(63,824)	(37,107)
Total operating cash flow .....	<u>\$ 722,424</u>	<u>686,638</u>	<u>662,690</u>

*Note:* Discovery commerce, education & other includes intercompany eliminations. Certain prior period amounts have been reclassified to conform to the current period presentation.

*Revenue.* Discovery's consolidated revenue increased 13% for each of the years ended December 31, 2006 and 2005 as compared to the corresponding prior year. Increased revenue was primarily due to increases of 20% and 23% in distribution revenue for 2006 and 2005, respectively, as well as an increase of 5% in advertising revenue for each of the same periods. Other revenue increased 17% and 12% for 2006 and 2005.

Distribution revenue increased \$128,901,000 or 18% and \$130,609,000 or 22% at the U.S. networks during the years ended December 31, 2006 and 2005, respectively. These increases are due to an 11% and 10% increase in paying subscription units for the years ended December 31, 2006 and 2005, respectively, combined with contractual rate increases. Launch amortization at the U.S. networks, a contra-revenue item, was \$72,585,000, \$67,750,000 and \$93,763,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Many of Discovery's domestic networks are currently distributed to substantially all of the cable television and direct broadcast satellite homes in the U.S. Accordingly, the rate of growth in U.S. distribution revenue in future periods is expected to be less than historical rates.

At the international networks, distribution revenue increased 23% and 25% during 2006 and 2005, respectively. Such increases were principally comprised of combined revenue growth in Europe and Latin America of \$96,897,000 during 2006 and growth in Europe and Asia of \$79,767,000 during 2005, resulting from a 2006 increase in paying subscription units of 13% combined with contractual rate increases in certain markets. Discovery also experienced a 2006 full year impact of new channel launches in Italy, France and Germany. Subsequent to December 31, 2006, Discovery completed negotiations for the renewal of long-term distribution agreements for certain of its European cable networks and paid a distributor \$185.4 million. Such payment will be amortized over a five year term, resulting in an approximate \$35 million annual reduction in international distribution revenue.

Advertising revenue, which includes revenue from paid programming, experienced a 5% increase for each of the years ended December 31, 2006 and 2005, with a \$34,710,000 or 14% increase at the international networks and a \$20,879,000 or 2% increase at the U.S. networks from 2005 to 2006. The increase in international networks advertising revenue was due primarily to higher viewership in Europe and Latin America combined with an increased subscriber base in most markets worldwide. The increase in advertising revenue at the U.S. networks was primarily due to higher advertising sell-out rates and higher audience delivery on certain channels. Paid programming, where Discovery sells blocks of time primarily for infomercials that are aired during the overnight hours on certain networks, represented 6% of total advertising revenue for each of the years ended December 31, 2006, 2005 and 2004.

The increase in advertising revenue during 2005 was primarily due to a 28% increase at the international networks. Over two-thirds of the international networks' advertising revenue is generated by its operations in the United Kingdom and Europe. The increase in international networks advertising revenue was comprised of a \$36,926,000 increase resulting from higher viewership in the U.K. combined with an increased subscriber base in the U.K. and Europe. Advertising revenue at the U.S. networks was essentially flat in 2005, increasing \$1,316,000, as higher rates at certain of the larger networks, combined with growth at other newer networks, was offset by decreases resulting from lower audience delivery at certain of the larger networks.

With 12 domestic channels, Discovery offers solutions to advertisers that allow them to reach a broad range of U.S. audience demographics in the face of increasing fragmentation of audience share. The television industry is facing several issues with regard to its advertising revenue, including (1) audience fragmentation caused by the proliferation of other television networks, video-on-demand and off-networks from cable and satellite companies and broadband content offerings; (2) the deployment of digital video recording devices, allowing consumers to time shift programming and skip or fast-forward through advertisements; and (3) consolidation within the advertising industry, shifting more leverage to the bigger agencies and buying groups.

Commerce, education and other revenue increased \$10,577,000 and \$10,959,000 related to the education business and increased \$10,051,000 and \$9,163,000 related to the commerce business for the years ended December 31, 2006 and 2005, respectively. During the fourth quarter of 2006, Discovery made a number of organizational and strategic adjustments to its education business to focus the resources dedicated to the company's direct-to-school distribution platform, *unitedstreaming*, as well as the division's other premium direct-to-school subscription services. Subsequent to December 31, 2006, Discovery initiated a strategic review of its commerce business to evaluate potential new operating alternatives with respect to such business unit.

**Cost of Revenue.** Cost of revenue increased 14% and 16% for the years ended December 31, 2006 and 2005, respectively. As a percent of revenue, cost of revenue was 37%, 37% and 36% for the years ended December 31, 2006, 2005 and 2004, respectively. The \$140,612,000 increase in 2006 primarily resulted from a \$94,981,000 increase in content amortization expense due to continued investment in original productions across the U.S. networks combined with increases in Europe associated with the launch of several networks to create a package of lifestyle-focused programming, along with a new free-to-air channel in Germany branded as DMAAX.

The increase in 2005 primarily resulted from a \$106,901,000 increase in content amortization expense due to continued investment across all U.S. networks in original productions and high profile specials and continued investment

in the lifestyles category internationally, particularly in Europe. These increases were offset partially by a net aggregate benefit of approximately \$11 million related to reductions in estimates for music rights accruals.

**SG&A Expenses.** SG&A expenses increased 16% and 17% during the years ended December 31, 2006 and 2005, respectively. As a percent of revenue, SG&A expense was 39%, 38% and 36% for the years ended December 31, 2006, 2005 and 2004, respectively. During 2006, SG&A expenses increased \$32,535,000, \$67,275,000 and \$50,817,000 in the U.S. networks, international networks and education groups, respectively. SG&A expense within the commerce group was relatively consistent with the prior year period. In U.S. networks, the increase is primarily due to a \$33,312,000 or 20% increase in personnel expense resulting from compensation increases combined with increased headcount from acquisitions. In international networks, the increase is primarily due to a \$38,202,000 or 32% increase in personnel expense, resulting from infrastructure expansions in Europe and Asia which increased headcount and office locations, a \$5,888,000 or 7% increase in marketing expense resulting from marketing campaigns in Europe and Asia for the launch of new channels and a \$16,920,000 or 16% increase in general and administrative expenses to support the growth of the business, coupled with the effects of foreign currency exchange rates. As a percent of revenue, international SG&A expense was consistent at 43% for both of the years ended December 31, 2006 and 2005. In the education group, the increase is primarily due to (i) a \$23,539,000 or 98% increase in personnel expense, resulting primarily from a full year of salary expense for headcount hired in 2005 and (ii) a \$19,142,000 or 174% increase in marketing expense resulting mainly from Discovery's investment in Cosmeo, a new consumer homework help service. In 2007, Discovery implemented cost cutting measures in its education group which should reduce personnel expense for that group in comparison to 2006.

Within the different business segments during 2005, SG&A expense decreased 2% at the U.S. networks and increased 34% and 65% at the international networks and Discovery commerce, education and other, respectively. The increase at the international networks was caused by a \$27,872,000 increase in personnel expense resulting from adding headcount as the business expands, particularly in the U.K. and Europe combined with a \$27,124,000 increase in marketing expense associated with branding and awareness efforts related to the lifestyles category initiative. The increase at Discovery commerce, education and other is comprised of a \$34,329,000 increase primarily resulting from acquisitions and organic growth in Discovery's education business.

**Expenses Arising from Long-term Incentive Plans.** Expenses arising from long-term incentive plans are related to Discovery's unit-based, long-term incentive plans, or LTIP, for its employees who meet certain eligibility criteria. Units are awarded to eligible employees and vest at a rate of 25% per year. In August 2005, Discovery discontinued one of its LTIPs and settled all amounts with cash. Discovery established a new LTIP in October 2005 (the "2005 LTIP Plan") for certain eligible employees pursuant to which participants in Discovery's remaining plan could elect to (1) continue in such plan or (2) redeem vested units and convert partially vested units to the 2005 LTIP Plan. Substantially all participants in the remaining plan redeemed their vested units and received partially vested units in the 2005 LTIP Plan. Certain eligible employees were also granted new units in the 2005 LTIP Plan. The value of units in the 2005 LTIP Plan is indexed to the value of DHC Series A common stock, and upon redemption, participants receive a cash payment based on the change in market price of DHC Series A common stock. Under the old plans, upon exercise, participants received a cash payment for the increase in value of the units from the unit value on the date of issuance determined by the year over year change in Discovery's aggregate equity value, using a consistent methodology. The change in unit value of LTIP awards outstanding is recorded as compensation expense over the period outstanding. Compensation expense aggregated \$39,233,000 and \$49,465,000 for the years ended December 31, 2006 and 2005, respectively. The decrease is primarily the result of the change in unit value determination for the 2005 LTIP Plan units. If the remaining vested LTIP awards at December 31, 2006 were redeemed, the aggregate cash payments by Discovery would be approximately \$36,650,000.

**Depreciation and Amortization.** The increase in depreciation and amortization for the year ended December 31, 2006 is due to an increase in new assets placed in service combined with acquisition activity occurring during 2006. The decrease in depreciation and amortization for the year ended December 31, 2005 is due to intangibles becoming fully amortized and a decrease in the depreciable asset base resulting from a reduction in the number of retail stores, offset by new assets placed in service during 2005.

**Gain on Sale of Patents.** In 2004, Discovery recorded a gain on the sale of certain of its television technology patents. The \$22 million gain represents the sale price less the costs incurred to sell the patents. The cost of developing the technology had been expensed in prior years to SG&A expense. Discovery does not expect a significant amount of income from patent sales in the future.

#### **Other Income and Expense**

**Interest Expense.** The increase in interest expense during the years ended December 31, 2006 and 2005 is primarily due to higher levels of outstanding debt in both years combined with increases in interest rates during those periods.

*Unrealized Gains from Derivative Instruments, net.* Unrealized gains from derivative transactions relate, primarily, to Discovery's use of derivative instruments to modify its exposure to interest rate fluctuations on its debt. These instruments include a combination of swaps, caps, collars and other structured instruments. As a result of unrealized mark to market adjustments, Discovery recognized \$10,352,000, \$29,109,000 and \$44,060,000 in unrealized gains on these instruments during the years ended December 31, 2006, 2005 and 2004, respectively. The foreign exchange hedging instruments used by Discovery are spot, forward and option contracts. Additionally, Discovery enters into non-designated forward contracts to hedge non-dollar denominated cash flows and foreign currency balances.

*Minority Interests in Consolidated Subsidiaries.* Minority interest represents increases and decreases in the estimated redemption value of mandatorily redeemable interests in subsidiaries which are initially recorded at fair value.

*Other.* Other income in 2006 relates primarily to Discovery's equity share of earnings on their joint ventures. Other income in 2005 relates primarily to the gain on sale of one of Discovery's investments.

*Income Taxes.* Discovery's effective tax rate was 46%, 50% and 46% for 2006, 2005 and 2004, respectively. Discovery's effective tax rate differed from the federal income tax rate of 35% primarily due to foreign and state taxes.

#### **Liquidity & Capital Resources**

Discovery generated \$479,911,000, \$68,893,000 and \$124,704,000 of cash from operations during the years ended December 31, 2006, 2005 and 2004, respectively. Discovery's payments under its long-term incentive plans were \$841,000, \$325,756,000 and \$240,752,000 for each of the same periods, respectively, driving a significant use of cash in 2005 and 2004. For a further discussion of Discovery's LTIP, please see Note 14 to the Discovery consolidated financial statements.

One of Discovery's primary investing activities in 2006, 2005 and 2004 was payments of \$180,000,000, \$92,874,000 and \$148,880,000, respectively, to acquire mandatorily redeemable securities related to minority interests in certain consolidated subsidiaries. In 2006, \$100,000,000 and \$80,000,000 was paid for the New York Times and the British Broadcasting Corporation mandatorily redeemable securities, respectively. Discovery also spent \$90,138,000, \$99,684,000 and \$88,100,000 on capital expenditures during the years ended December 31, 2006, 2005 and 2004, respectively. During the same periods, Discovery paid \$194,905,000, \$400,000 and \$17,218,000 for business acquisitions, net of cash acquired.

In addition to cash provided by operations, Discovery funds its activities with proceeds borrowed under various debt facilities, including a term loan, two revolving loan facilities and various senior notes payable. During the year ended December 31, 2006, net incremental borrowings under debt facilities aggregated approximately \$16,813,000. Total commitments of these facilities were \$4,059,000,000 at December 31, 2006. Debt outstanding on these facilities aggregated \$2,607,000,000 at December 31, 2006, providing excess debt availability of \$1,452,000,000. Discovery's ability to borrow the unused capacity is dependent on its continuing compliance with its covenants at the time of, and after giving effect to, a requested borrowing.

All term and revolving loans and senior notes are unsecured. The debt facilities contain covenants that require Discovery to meet certain financial ratios and place restrictions on the payment of dividends, sale of assets, additional borrowings, mergers, and purchases of capital stock, assets and investments. Discovery has indicated it is in compliance with all debt covenants at December 31, 2006.

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In 2007, Discovery expects to spend approximately \$100,000,000 for capital expenditures and \$180,000,000 for interest expense. Payments to satisfy LTIP obligations are not expected to be significant in 2007. Discovery believes that its cash flow from operations and borrowings available under its credit facilities will be sufficient to fund its working capital requirements.

*Contractual Obligations.* Discovery has agreements covering leases of satellite transponders, facilities and equipment. These agreements expire at various dates through 2020. Discovery is obligated to license programming under agreements with content suppliers that expire over various dates. Discovery also has other contractual commitments arising in the ordinary course of business.

A summary of all of the expected payments for these commitments as well as future principal payments under the current debt arrangements and minimum payments under capital leases at December 31, 2006 is as follows:

	Payments due by period(2)				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
	amounts in thousands				
Long-term debt .....	\$2,607,300	—	860,300	1,032,000	715,000
Capital leases .....	38,900	9,300	14,600	9,600	5,400
Operating leases .....	505,228	87,049	141,494	100,615	176,070
Program license fees .....	559,633	318,523	109,849	87,424	43,837
Launch incentives .....	36,713	21,632	15,081	—	—
Other(1) .....	229,451	86,965	116,102	25,264	1,120
Total .....	<u>\$3,977,225</u>	<u>523,469</u>	<u>1,257,426</u>	<u>1,254,903</u>	<u>941,427</u>

- (1) Represents Discovery's obligations to purchase goods and services whereby the underlying agreements are enforceable, legally binding and specify all significant terms. The more significant purchase obligations include: agreements related to audience ratings, market research, contracts for entertainment talent and other education and service project agreements.
- (2) The table above does not include certain long-term obligations reflected in the Discovery consolidated balance sheet as the timing of the payments cannot be predicted or the amounts will not be settled in cash. The most significant of these obligations is the \$84.5 million accrued under Discovery's LTIP plans. In addition, amounts accrued in the Discovery consolidated balance sheet related to derivative financial instruments are not included in the table as such amounts may not be settled in cash or the timing of the payments cannot be predicted.

Discovery is subject to certain contractual agreements that may require Discovery to acquire the ownership interests of minority partners. At the end of 2006, Discovery estimates its aggregate obligations thereunder at approximately \$94.8 million. The put rights are exercisable at various dates. In January 2007, Discovery exercised its rights and paid \$44.5 million to acquire certain redeemable equity.

#### **Item 7A. Quantitative and Qualitative Disclosures about Market Risk.**

##### **Foreign Currency Risk**

We continually monitor our economic exposure to changes in foreign exchange rates and may enter into foreign exchange agreements where and when appropriate. Substantially all of our foreign transactions are denominated in foreign currencies, including the liabilities of our foreign subsidiaries. Although our foreign transactions are not generally subject to significant foreign exchange transaction gains or losses, the financial statements of our foreign subsidiaries are translated into United States dollars as part of our consolidated financial reporting. As a result, fluctuations in exchange rates affect our financial position and results of operations.

#### **Item 8. Financial Statements and Supplementary Data.**

Our consolidated financial statements are filed under this Item, beginning on Page II-17. The financial statement schedules required by Regulation S-X are filed under Item 15 of this Annual Report on Form 10-K.

#### **Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

#### **Item 9A. Controls and Procedures.**

In accordance with Exchange Act Rules 13a-15 and 15d-15, the Company carried out an evaluation, under the supervision and with the participation of management, including its chief executive officer, principal accounting officer and principal financial officer (the "Executives"), of the effectiveness of its disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Executives concluded that the Company's disclosure controls and procedures were effective as of December 31, 2006 to provide reasonable assurance that information required to be disclosed in its reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

See page II-15 for Management's Report on Internal Control Over Financial Reporting.



See page II-16 for Report of Independent Registered Public Accounting Firm for our accountant's attestation regarding our internal controls over financial reporting.

There has been no change in the Company's internal controls over financial reporting identified in connection with the evaluation described above that occurred during the three months ended December 31, 2006 that has materially affected, or is reasonably likely to materially affect, its internal controls over financial reporting.

**Item 9B. Other Information.**

None.